HOUSE BUDGET COMMITTEE

Democratic Caucus

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July 16, 2003

Deficits Hit Record Levels: Administration Shows No Shame, Shock or Solution

Overview

There is no way for the Bush Administration to put a pretty face on the deficit projections released yesterday.

- The President acknowledges that the deficit this year and next will set new records — $455 billion in 2003 and $475 billion in 2004. The previous record deficit was $290 billion in 1992.

- Thereafter, the Administration foresees deficits well in excess of $200 billion per year, even though it assumes the economy grows quite strongly — starting now.

- The Administration's own figures show the deficit starting to worsen again in 2008 just before its truncated five-year budget window closes.

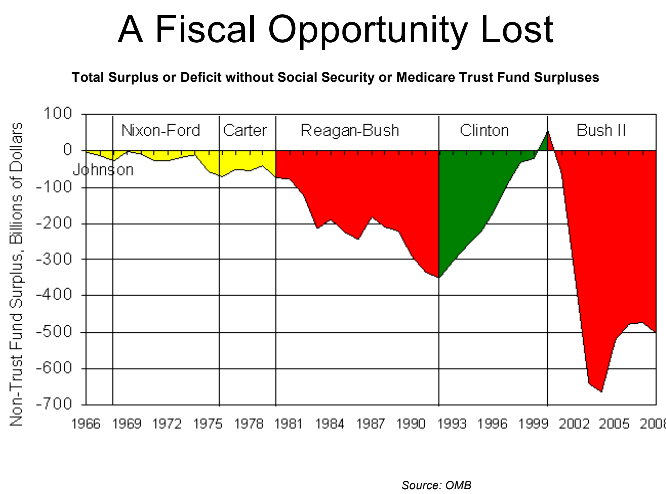
- OMB's figures show that these deficits will increase publicly held debt to $5.5 trillion in 2008 from $3.5 trillion currently. In fact, the Administration's figures show public debt growing faster than the economy, which is not sustainable over the long run.

But the Administration shows no shame, expresses no shock and offers no solutions.

- The President claims that better economic growth might eventually close the deficit, but these projections already assume strong growth.

- The President claims that spending discipline also will eventually close the deficit, but these projections already incorporate all the spending restraint that he has asked for.

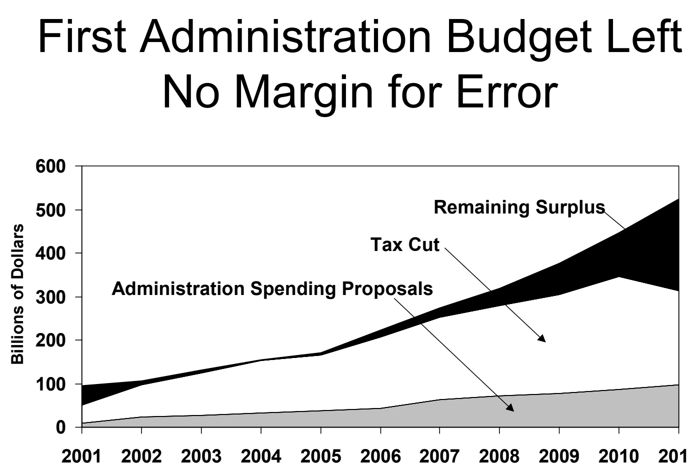
The Administration blames this deficit on terrorism and recession, and both have taken their toll. But the President downplays the impact of his tax cuts, which have absorbed a huge amount of resources and which left no room for error.



- From 2001 through 2011, the total budget impact (including added interest on the national debt) of the 2001, 2002, and 2003 tax cuts comes to $3.7 trillion. This assumes that the tax cuts are made permanent and middle-class families are protected from the alternative minimum tax (AMT) as the President has asked, and also includes added spending for interest on the public debt.

- During the same period, deficits are likely to total $3.6 trillion, essentially equal to the total budgetary impact of the President's entire tax agenda.

Each of the Administration's five previous budget forecasts has proved too optimistic, and this year's *Mid-Session Review* would appear to continue the pattern.



April 2001 Projection of Non-Medicare, Non-Social Security Surplus;
Tax and Spending Proposals in House-Passed Budget Resolution for FY2002

- For instance, last year's *Mid-Session Review* predicted that the 2003 deficit would be $109 billion (versus $455 billion now) and that the budget would return to unified surplus in 2005. Now, OMB projects a deficit in FY 2005 of $304 billion, and foresees only meager improvement thereafter.

As troubling as these new OMB estimates are, the picture is far worse than the Administration recognizes for five reasons.

- The Administration estimates in 2004 leave out important and costly items like the cost of our deployments in Iraq and Afghanistan. The Pentagon estimates the cost is about $5 billion per month.

- OMB omits the cost of sheltering millions of middle-income families from the effects of the alternative minimum tax. This tax, which was originally intended to affect only the most affluent taxpayers, will impact 40 million taxpayers before the decade is out. The Administration claims it wishes to solve this problem, but its budget nowhere shows the cost of doing so.

- The Administration assumes large and unspecified cuts to domestic appropriations that occur far in the future.

- The Administration shows only five-year, rather than ten-year, estimates, even though many of its priorities — such as repealing the tax cut sunsets and prescription drugs — have large costs that show up only after 2008.

- OMB continues to use optimistic economic assumptions, assuming that a surge of strong economic growth is upon us. Unfortunately, the latest data show the economy continuing to lose jobs with little prospect of a turnaround.

The Administration continues to wink at the danger of huge deficits and the likelihood that they will get even worse. The timing of such fiscal indifference could not be worse. In just five years, the first of the Baby Boom generation will begin to retire, putting significant strains on the government's finances. Entering such a period of financial stress already encumbered with chronic and corrosive deficits is a recipe for disaster.

The *Mid-Session Review* Sets Records

The *Mid-Session Review* predicts that the budget deficits for this fiscal year and next will be the two largest in American history. For fiscal year 2003 (which ends on September 30), the Administration estimates that the total, or "unified," deficit will be a record $455 billion; for 2004, the deficit is a projected $475 billion.

For 2003, 2004, and 2005, the *Mid-Session Review* increases the projected deficits from the Administration's budget, presented just five months ago, by half. Even the expected 2005 deficit, at $304 billion, is larger than the previous record, which was $290 billion in 1992, the last year of the previous Republican Administration.

OMB anticipates that the budget will improve for a time after 2004, dropping from $475 billion to the $304 billion figure in 2005, and then to $238 billion. Thereafter, however, progress essentially ceases, with the deficit fluctuating to $213 billion in 2007, then rising to $226 billion in 2008.

With the retirement of the baby-boom generation rapidly approaching — most of the first of that group, those born in 1946, will begin collecting Social Security benefits at age 62, in 2008 — the unified deficit becomes an increasingly inadequate measure of our fiscal prospects. Because the Social Security Trust Fund surplus is temporary, the nation should focus more on the non-Social Security, or "on-budget," deficit. And by that measure, the budget outlook is truly dismal.

In 2003, the Administration estimates the on-budget deficit at a record $615 billion, far surpassing the previous high from 1992 of $340 billion. For 2004, OMB believes that the budget will set yet another record, at $639 billion. Most troubling is the fact that the on-budget deficit remains in record territory for the foreseeable future, with no signs whatever of long-term improvement. In 2005, the Administration projects the on-budget deficit at $490 billion, fluctuating thereafter at $441 billion, $435 billion, and $464 billion through 2008. All of those figures are higher than the previous record deficit of 1992.

A Broken Social Security Lock Box

Only two years ago, the Administration assured the nation that it would never touch the Social Security Trust Fund surplus to finance the day-to-day operations of government. For example, the *Mid-Session Review* of August 2001, stated:

> A strong bipartisan consensus has arisen in this country, and in the Congress, to preserve very large surpluses as a threshold condition of public finance. Both parties and both the Legislative and Executive Branches, in this Administration and the previous one, have concurred in maintaining a surplus at least the size of the Social Security surplus . . .
>
> Some would set the minimum surplus level even higher, using as a target the artificial overage in the Medicare Part A trust fund . . .
>
> The update of the budget outlook in this Mid-Session Review foresees continued large surpluses above the size of the Social Security surplus for all years in the budget horizon. The President is determined to preserve surpluses at this level, and to continue using these funds for the steady reduction of outstanding publicly held debt.

Of course, the Administration's words rang hollow even then. The Congressional Budget Office (CBO) projected at the same time that the budget would violate that "threshold condition of public finance" in three of the next five years, with an insufficient balance to protect the Medicare Trust Fund Surplus in the other two. But that problem pales in comparison to the situation today. The current *Mid-Session Review* anticipates the dissipation of the entire Social Security and Medicare Trust Fund surpluses over each of the next five years, with no sign of improvement, and no plan to solve the problem. And the retirement of the baby boom, beginning within this five-year window, bodes ill for this trend.

The *Mid-Session Review* responds to this alarm bell with no shame, no shock, and no solution. It provides only more of the same indiscriminate tax-cutting strategy that got us to this perilous point.

Administration Numbers Are Overly Optimistic

The *Mid-Session Review* revises the current budget numbers significantly in the adverse direction, but indicates that the situation will vastly improve in just a few years. Every budget document since the enactment of the Administration's 2001 tax cuts has made the same claim. But the adverse developments have continued with every turn of the fiscal cycle, and the budget has not yet turned the corner into the rosy long run.

- ***Hope For the Economy Springs Eternal*** — The Administration's economic and technical assumptions contribute to the hopeful outlook. Though the economy is now weak, the Administration assumes that a strong pickup is immediately at hand. Economic growth will have to bounce from the current pace of one to two percent per year up to four percent right now to reach the OMB target of growth of almost three percent for this year as a whole. Thereafter, the Administration's economists see 2004 growth even faster now than they did in the budget five months ago.

- ***Corporate Profits Will Skyrocket*** — OMB expects an enormous jump in corporate profits in 2005, brought about by the expiration of the "bonus depreciation" provision of the 2002 stimulus tax cut, which was liberalized and extended in the recently enacted 2003 tax cut. Many Republicans in the Congress advocate making that tax cut permanent.

- ***But Interest Rates Remain Unchanged*** — And even though it forecasts a rapid pickup in economic growth, the Administration assumes that interest rates will remain significantly lower than it had expected in February. This is most helpful to the budget, because with deficits as high as expected now, the federal government will accumulate a great deal of debt.

- ***Technical Estimates Left Fuzzy*** — The *Mid-Session Review* does not make clear its technical assumptions regarding the future path of revenues; the document combines the economic and technical reestimates to the receipts totals. This is not helpful to public understanding, because economic reestimates will tend to reverse themselves when the economy eventually resumes its growth, but technical reestimates are less likely to do so. The Administration's hopeful forecast includes the projection that total receipts will jump from 16.3 percent of GDP in 2003 (the lowest ratio since 1959) and 16.0 percent in 2004 (the lowest since 1950) to 17.8 percent in 2006, and 18.1 percent in 2007 and 2008. In the last two years, receipts have been much weaker even than the sluggish economy would suggest (and the economy has not responded to the tax-cut medicine that was supposed to ensure robust economic growth).

Every Administration budget document beginning with August of 2001 has projected such a turnaround in budget outcomes. There is little indication that the end of the rainbow is any nearer now than it was then.

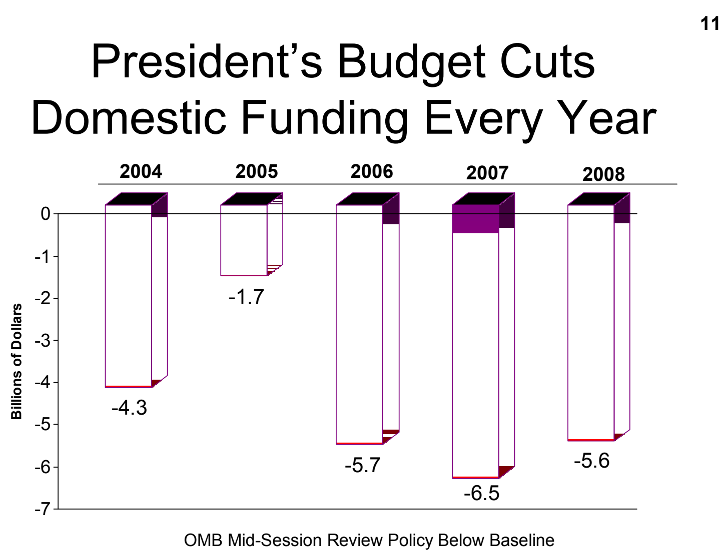
Domestic Appropriations Cut, Not Increased

The *Mid-Session Review* appears to show a 3.6 percent increase in appropriations from 2003 to 2004, with 2.0 percent growth in non-homeland security, non-defense funding (Table 10, page 42). That table is misleading because it shows that we are spending nothing on the war now or in the future, and omits other 2003 funding. In total, Table 10 omits $89 billion in enacted 2003 appropriations and another $1.9 billion in requested supplemental appropriations.

In reality, the Administration is likely to request additional defense funding for 2004 to cover the costs of the war, and to eliminate some of the $16 billion in non-defense funding included in the 2003 Iraq War supplemental funding bill. If Table 10 had included all the funding Congress enacted for 2003, it would more accurately show that nominal domestic funding is cut by $3 billion (0.8 percent) from 2003 to 2004.

- ***Budget Contains Unrealistic Cuts in Appropriations Every Year*** — It is unrealistic to assume that funding will decrease at a time when we are not only at war but face pressing national priorities in homeland security, education, and other areas. In fact, as shown in the accompanying chart, the President's budget continues to cut domestic appropriations below OMB's own estimate of current purchasing power (the baseline) every year.

- ***Appropriations Cuts Will Not Erase the Deficit*** — Republicans often cite growth in discretionary spending as the cause of increasing deficits. But the size of foreseeable annual deficits is greater than the sum of all domestic funding. Even if we eliminated all domestic appropriations — stopped all federal funding for education, law enforcement, scientific research, the environment, public health, etc. — we would still run a deficit of close to $100 billion in 2003 and of $120 billion in 2004.



Other Understated Costs

- ***Ignoring Future Costs of Operations in Iraq and Afghanistan*** – The President's budget included no funding for the war against Iraq, for post-war operations in Iraq, or for ongoing anti-terrorism military operations in Afghanistan. In April, Congress enacted a $79.2 billion supplemental to cover these costs, related aid to allies, and other unrelated costs. Of this amount, $62.8 billion was provided for national defense activities. However, this supplemental will only cover the costs incurred in 2003. The budget includes no funding for these activities in 2004 or beyond, and the projections in the *Mid-Session Review* continue to ignore these future costs. On July 9, Secretary of Defense Rumsfeld testified that the Department of Defense (DOD) is currently spending about $3.9 billion per month in Iraq. In addition, DOD is currently spending $950 million a month in Afghanistan. On July 10, the recently retired commander of U.S. forces in Iraq and Afghanistan, General Franks, testified that the current size of our forces in Iraq was about right for the foreseeable future, and that our forces could remain in Iraq at some level for two to four years. If current levels of effort remain unchanged, we could be facing $58 billion in unfunded DOD costs for 2004: $47 billion in Iraq and $11 billion for the war on terrorism in Afghanistan.

- ***Ignores AMT*** – Similarly, the President's budget last year took notice that the alternative minimum tax (AMT), unless changed, will affect 39 million tax filers by 2010, up from about 2 million currently. By then the AMT will burden more than half of all families with children. Even though the AMT will take away many of the tax cuts the President is promising and will oblige millions of middle-class families to figure their taxes twice and pay more, the President's budget does not show the approximately $700 billion cost for comprehensive AMT reform.

- ***Omits Cost of Social Security Transition*** –The Administration's budget also omits the roughly $1 trillion that would be needed to fund private stock-market accounts as a replacement for Social Security, as called for by the President. Whether one believes in strengthening the existing Social Security program or in privatizing it as the President has suggested, significant budgetary resources ***from outside of Social Security*** will be needed. With the budget's dramatic turn from burgeoning surpluses to chronic deficits, though, those resources no longer exist. Yet, the President's budget does not recognize this, calling into question his professed concern for long-term fiscal stability and the viability of Social Security and Medicare.

- ***Five-Year Estimates Cloak Size of Out-Year Deficits*** — The Administration provides deficit numbers only for the next five years, despite the fact that many of its priorities, such as repealing the tax cut sunsets and providing prescription drug coverage under Medicare, have large costs that show up only after 2008. Prior to last year, OMB's practice was to provide estimates covering ten years, not five years. Indeed, the Administration's first budget embraced ten-year projections because the huge surplus projected for the next decade supposedly justified huge, back-loaded tax cuts. Now, with the return of large, chronic deficits, the Administration claims that ten-year estimates cannot be trusted.

A More Realistic View

The Administration's *Mid-Session Review* continues the pattern of its four previous budget forecasts: ever worsening near-term deficits, with improvement just around the corner. That improvement has not yet materialized, despite three rounds of tax cuts, costing the Treasury well over $2 trillion (and almost as much again to make the expiring provisions in those laws permanent). It is long past time to consider whether our budget might be well off course.

The House Budget Committee Democratic staff has constructed an alternative estimate, based on the economic forecast and baseline budget projections of the non-partisan Congressional Budget Office. That estimate is adjusted to account for enacted tax cut legislation and the war in Iraq; a realistic technical adjustment to future receipts, which assumes that the unexplained shortfalls of the last two years will continue; and the enactment of the remainder of the Republican agenda, including the President's defense buildup and proposed tax cuts. A final policy assumption is a repair of the ballooning individual alternative minimum tax (AMT), which according to Administration estimates will extend its reach from about 1.5 million taxpayers in 2001 to about 39 million taxpayers in 2012. Although some would argue that the continuation of the large current budget deficits would increase interest rates once the expected economic recovery begins, we make no such assumption.

The following table shows the results:

- ***Big Deficits*** — An on-budget deficit this year of $579 billion is reduced to $416 billion when the Social Security surplus ($163 billion) is included. Over the next ten years, on-budget deficits total $6,527 billion, reduced to a unified deficit of $3,959 billion when the Social Security surplus ($2,568 billion) is offset against the on-budget deficits.

- ***More Debt*** — Debt held by the public increases from $3,540 billion at the end of last year to $7,915 billion by the end of 2013. This is an increase from 34 percent to 44 percent of GDP; in other words, the public debt is growing faster than the economy. In 2001, CBO projected that we could pay off this debt by 2008 by following a current services budget. Instead, we will now have a debt of $3,983 billion by 2008.

- ***Higher Interest Payments*** — Debt service costs increase from about $156 billion this year to $418 billion by 2013. Two years ago, the Administration projected that by 2011, the nation would be debt-free and so would have no interest costs — even after its large tax cuts.

To date, the Administration has made twice-annual adverse reestimates of its short-term budget outlook, but has refused to recognize that, with the repetition of that habit over a period of years, the short run will become the long run. The sooner the Administration and the Congress recognize the ongoing deterioration of the budget and begin to consider serious solutions, the better off the nation will be.

BUDGET OUTLOOK WITH CONFERENCE TAX CUTS

CBO Assumptions, Fiscal Years, Billions of Dollars; Surplus Is Positive

March 2003 Baseline	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-2013	2002-2011
Unified Surplus	-158	-246	-200	-123	-57	-9	27	61	96	231	405	459	891	-377
On-Budget Surplus	-317	-408	-373	-317	-269	-240	-224	-207	-190	-73	88	128	-1,678	-2,619
Off-Budget Surplus	160	163	173	195	212	231	250	268	286	304	318	331	2,568	2,241
Technical Reestimate	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-2013	2002-2011
Receipts	0	-67	-59	-54	-52	-51	-51	-50	-50	-50	-50	-50	-517	-484
Legislation	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-2013	2002-2011
Iraq War Supplemental	0	-38	-27	-7	-1	0	0	0	0	0	0	0	-36	-75
Conference Tax Cuts	0	-61	-149	-82	-21	-14	-17	-11	-4	4	3	2	-289	-354
Subtotal	0	-166	-234	-144	-74	-65	-67	-62	-54	-46	-47	-48	-842	-913
Debt Service on Above	0	-1	-9	-22	-31	-37	-43	-49	-55	-61	-66	-73	-445	-307
Possible August Baseline	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-2013	2002-2011
Unified Surplus	-158	-413	-443	-288	-162	-111	-84	-49	-13	124	292	338	-396	-1,596
On-Budget Surplus	-317	-576	-616	-483	-374	-342	-334	-317	-300	-179	-26	6	-2,965	-3,838
Omitted Costs	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-2013	2002-2011
DISCRETIONARY														
Bush Defense Increase	--	0	0	-2	-8	-13	-22	-28	-32	-34	-36	-38	-212	-139
Further Cost of War	--	0	-30	-20	-10	0	0	0	0	0	0	0	-60	-60
REVENUES														
Extend Conference Agreement	--	0	-1	-15	-78	-78	-71	-72	-82	-85	-86	-89	-656	-480
Bush Tax Cut (Over Conference)	--	-3	-10	-23	-27	-32	-37	-47	-46	-180	-283	-296	-981	-404
AMT Repair	--	0	-4	-12	-27	-41	-56	-73	-89	-107	-126	-146	-680	-408
MANDATORY														
Medicare Rx	--	0	0	0	-22	-34	-39	-44	-50	-63	-70	-78	-400	-252
Total Change	0	-3	-45	-71	-172	-197	-225	-264	-299	-468	-601	-647	-2,989	-1,744
Debt Service on Above	0	0	-1	-4	-11	-22	-34	-50	-68	-92	-126	-167	-574	-281
RESULTING DEFICIT	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-2013	2002-2011
Unified Surplus	-158	-416	-489	-364	-345	-329	-343	-363	-380	-436	-435	-476	-3,959	-3,621
On-Budget Surplus	-317	-579	-662	-558	-557	-560	-594	-631	-666	-740	-753	-807	-6,527	-5,863
DEBT HELD BY THE PUBLIC	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-2013	2002-2011
CBO 2001 Baseline Debt	2,870	2,537	2,157	1,738	1,246	682	54	-651	-1,444	-2,314	N.A.	N.A.	N.A.	N.A.
CBO Current Baseline Debt	3,540	3,766	3,927	4,013	4,045	4,034	3,983	3,894	3,766	3,501	3,062	2,565	N.A.	N.A.
Debt With Policy	3,540	3,956	4,445	4,809	5,154	5,483	5,826	6,189	6,568	7,004	7,439	7,915	N.A.	N.A.
Difference	670	1,419	2,288	3,071	3,908	4,801	5,772	6,840	8,012	9,318	N.A.	N.A.	N.A.	N.A.
Debt With Policy, % of GDP	34%	37%	39%	40%	41%	41%	42%	42%	42%	43%	44%	44%	N.A.	N.A.

House Budget Committee Democratic Staff

29-May-03

Administration Downplays Effects of Tax Cuts

These new deficit estimates are a cause for alarm, and they demand a clear understanding of the policies and events that have caused them. Unfortunately, Republicans deny that the deficits are a problem — claiming that they are "manageable" — and seek to downplay the role that their tax cuts have played in creating the deficits. The Administration seeks to place the blame for the deficits on war, terrorism, and recession. Those factors have had an impact, but the Administration cannot escape the fact that its own fiscal and economic mismanagement has played a substantial role in creating these deficits.

Are Deficits Manageable?

Administration spokesmen and Republicans in Congress have defended the current large budget deficits, projected by the *Mid-Session Review* to continue indefinitely, as "manageable." This characterization is a bit incongruous coming from those who argued or voted time and again for a Social Security and Medicare Trust Fund surplus "lock box" that is, by these deficits, totally destroyed. However, the argument that current deficits are "manageable" falls on the merits as well.

The bright line between minimal fiscal responsibility and clear fiscal irresponsibility is the path of the nation's debt compared to its GDP — or, is the nation's debt growing faster than its income? By this standard, the *Mid-Session Review* has self-avowedly crossed the line, to the wrong side.

According to the Administration's own projections in the *Mid-Session Review,* the ratio of the public debt to the GDP will rise each year for the next four years — from the low point of 33.1 percent at the end of 2001 to 40.6 percent at the end of 2006. In the following two years, it falls minimally to 40.3 percent. This wipes out much of the progress of the previous Administration, which inherited a rising debt equal to almost half of the GDP, and turned the situation around.

Every family understands that it cannot achieve prosperity if its debt is growing faster than its income. The same is true of the nation as a whole. A debt growing faster than the GDP is not sustainable. If anything goes wrong — a recession, a foreign policy challenge, or a serious national emergency — the federal government is in the worst position to respond, and the debt will rise even faster. Growing debt and interest payments require higher taxes, or reductions in government services. And with the impending retirement of the baby-boom generation, a rising debt seriously limits the nation's options to safeguard Social Security and Medicare.

Furthermore, large deficits deplete the nation's pool of savings, and so reduce its business investment. That makes the economy weaker in the future, reducing productivity growth, wages, and prosperity. Also, interest rates are driven by the supply of and demand for credit, and budget deficits of the size envisioned in the *Mid-Session Review* will substantially increase the demand for credit, and so drive up interest rates. That inhibits business borrowing, and risks putting the federal budget into a vicious cycle in which debt, deficits and interest costs climb after each other without limit.

Some seem to believe that any budget deficits less than the highest historical percentage of GDP — 6.0 percent, in 1983 — are by that fact "manageable." They fail to recognize that deficits well below that level still can be large enough to grow our debt faster than our income. The deficits in the *Mid-Session Review* demonstrate that fact. With deficits and debt as large as now projected, the federal government will have no margin for error, and no resources with which to prepare for the pressures of population aging.

Has a Weak Economy Caused the Deficits?

The Administration also argues that the weak economy is largely responsible for the re-emergence of chronic budget deficits. This is incorrect. Certainly, a temporary economic downturn can cause a temporary worsening of the budget deficit. However, the President's own numbers show that budget deficits will remain large even if a robust economic expansion has already begun.

The Administration's budget forecast is premised on a prediction of an immediate and robust economic recovery. In the second half of this year — which has already begun — OMB expects real GDP to advance at more than a 4 percent annual rate. In 2004, OMB foresees 3.7 percent growth, followed by 3.5 percent in 2005. Thereafter, OMB expects growth to consistently exceed 3.0 percent per year.

Yet, the *Mid-Session Review* shows budget deficits exceeding $200 billion per year throughout the five-year budget window the Administration chooses to show, despite the assumption of an abrupt and strong economic expansion. Furthermore, the *Mid-Session Review* shows the budget deficit again worsening in 2008 when the first Baby Boomers begin to retire. This suggests that OMB chose not to show the budget deficits after 2008 that result from the President's policies because doing so would show the budget outlook continuing to deteriorate long after the economy is supposed to have recovered.

September 11 and the War in Iraq

- ***Cost of September 11 Is Not Primary Cause of Deficits*** — The Administration cites the response to the tragic events of September 11 as one of the causes of the budget deterioration, and, to be sure, the costs of responding to the attacks and strengthening homeland security have been significant. But the response to September 11 has not produced the budget deficits. Indeed, the budget had deteriorated substantially prior to September 11. OMB's August 2001 *Mid-Session Review* already showed that there were no longer surpluses available outside of the Medicare and Social Security surpluses. Last year, the nonpartisan Congressional Budget Office estimated that the ten-year cost of responding to September 11 — including increased homeland security funding — would total $435 billion, or $554 billion if interest costs are included. While this is a substantial sum, it is only a fraction of the budget deterioration that has occurred since this Administration took office.

- ***War in Iraq Is Not the Major Cause of Record Deficits*** – The war in Iraq is not the major cause of these record deficits. According to OMB estimates, the Iraq war will add $47 billion to the deficit in 2003. This represents only 10.3 percent of the projected 2003 deficit. Over the two-year period 2003 and 2004, it will add $67 billion in spending according to OMB estimates, which represents just 7.2 percent of the projected deficits. The primary problem with the cost of operations in Iraq is not that it is the major cause of these record deficits, but that even in the face of record deficits, this Administration presents no plan for dealing with the substantial additional unfunded costs of our presence in Iraq or Afghanistan. Not only are no tradeoffs proposed to offset all or part of the cost of these operations, which are currently costing a combined $4.8 billion a month, beyond 2003 the costs are not even acknowledged in any of the tables or forecasts in this document.

Excessive Tax Cuts Drive Deficits

The Administration's argument that economic conditions — rather than excessive tax cutting — have created deficits as far as the eye can see contradicts the Administration's budget presentation and does not hold up under scrutiny. The President has always argued that the tax cuts would have only a small budgetary impact. He has maintained that they largely pay for themselves by stimulating better economic performance and higher federal revenues, in turn. However, the tax cuts thus far have failed to deliver better economic growth. As a consequence, the budget impact of the tax cuts has indeed been severe because the cuts have not boosted the economy and tax collections. And, as pointed out above, even if one believes the President's prediction of an imminent strong recovery in response to tax cuts, the deficit remains large and growing at the end of the budget window, just as Social Security and Medicare costs will also begin to grow. This suggests the presence of a deficit that is structural, not cyclical.

The Administration and Republicans in Congress have claimed that the large deficits projected in the *Mid-Session Review* are caused by the response to terrorism and other threats to the national security. That claim is dubious.

- ***National Security Spending Not As Large As Deficits*** — For the current fiscal year (2003), the unified deficit is virtually as large as the combined amounts of total defense and homeland security spending (i.e., $455 billion for the deficit, versus $425 billion of outlays for defense, plus about $40 billion of outlays for homeland security). For next year, 2004, the $475 billion deficit is larger than the sum of defense (at $409 billion) and homeland security (again around $40 billion). In other words, over these two years, we would have a deficit, and would spend every dime of the Social Security and Medicare Trust Fund surpluses, even if we spent absolutely nothing on defense and homeland security.

Furthermore, comparing national security and the tax cuts as potential causes for the deficit is like comparing apples and oranges: national security spending is required, but the tax cuts were optional.

- ***Tax Cuts Larger Than Deficits*** — Instead, compare the cost of the tax cuts with the likely deficits over the next ten years. According to the House Budget Committee Democratic staff estimates, the full agenda of Republican proposed tax cuts, including making permanent the 2003 enacted tax cuts and the remaining tax cuts in the President's budget, with the consequent increased debt service cost, will total \$3.7 trillion over the ten years 2002-2011. Over the same time frame, the projected unified budget deficits come to \$3.6 trillion. Thus, without the cost of the tax cuts, there would be no ten-year budget deficit.

Some have answered that the tax cuts were necessary to pull the economy out of recession and restore economic growth, and hence to bring the deficit down. However, the economy is still sluggish, so the three tax cuts, which have cost well over \$2 trillion even before making all of their expiring provisions permanent, apparently have not worked very well. Those tax cuts were not well designed to stimulate the economy, because they were not fast-acting (much of their revenue cost comes in the out years, rather than up front, when the economy needs the stimulus) and provided much of their benefit to the most well-to-do taxpayers, who were least likely to spend the money and increase demand, hiring, and investment. Furthermore, believing that tax cuts reduce the deficit requires believing that tax cuts more than pay for themselves — that is, they generate so much economic growth that they not only replace their own direct revenue cost, but yield still more revenue besides. Even staunch supply-side economists have derided such contentions as myths created by tax-cut opponents to paint tax-cut advocates as irresponsible:

> Liberals have been doing this for more than 20 years with the Reagan tax cut, falsely claiming that it was not supposed to lose any revenue because of its stimulative effect on the economy. By setting up such a ridiculous standard of success, they can thereby proclaim the Reagan tax cut to have been a failure due to the deficits of the 1980s.
>
> It doesn't matter that no responsible economist, inside or outside the Reagan administration, ever said that the tax cut would instantaneously pay for itself. (Bruce Bartlett, "Bias Against Tax Cuts," May 30, 2003.)

So the total costs of defense and homeland security are smaller than the projected deficits this year and next. The truly incremental costs for the new threats of the last two years are much smaller still. The three tax cuts, which to date have not brought the economy back, have drained the Treasury to the full measure of the projected budget deficits. The tax cuts are a central contributor to the growth of projected deficits and debt in the long run.

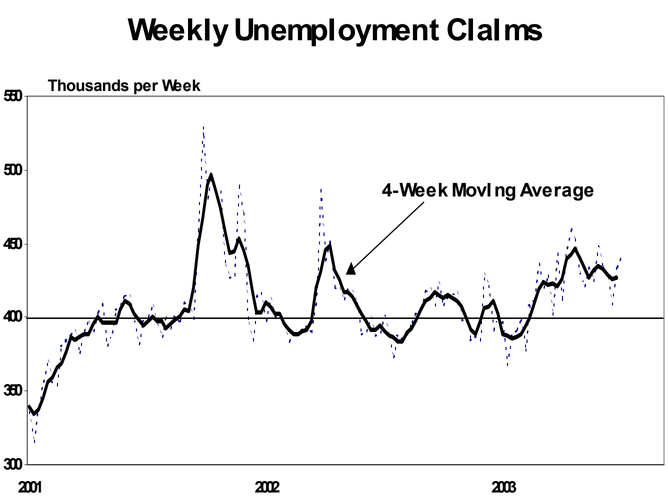
Economic Data Do Not Support Administration's Claim That the Economy Already Is Growing at Over 4.0 Percent Per Year

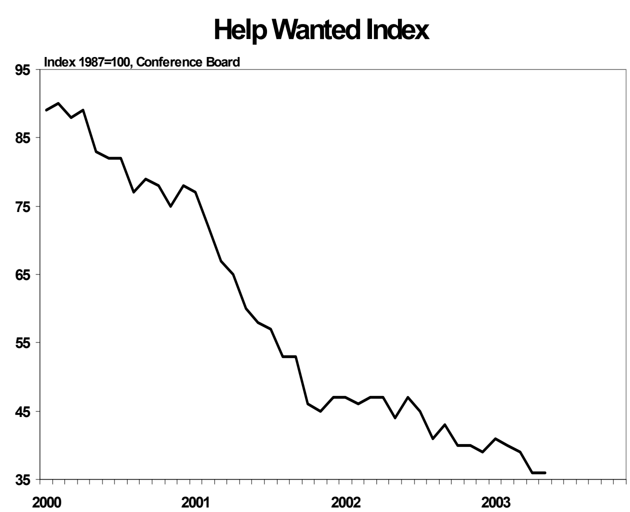
The startling deficits in the *Mid-Session Review* are based on an assumption that the economy already has begun strong economic growth. However, a wide variety of economic indicators continue to show that the economy still is flat and, indeed, losing jobs. Ironically, the three Republican tax cuts of the last two years, which were supposed to deliver a better economy and a smaller deficits, have failed on both counts.

Growth for the rest of this year will almost certainly fall short of what the Administration assumes. The Administration's new deficit projections assume that real GDP growth is now accelerating to more than a 4-percent rate for the third and fourth quarters of this year. However, there are no credible signs in the data that such a robust expansion has begun as yet. Without such an expansion, the deficits will be even larger than OMB predicts.

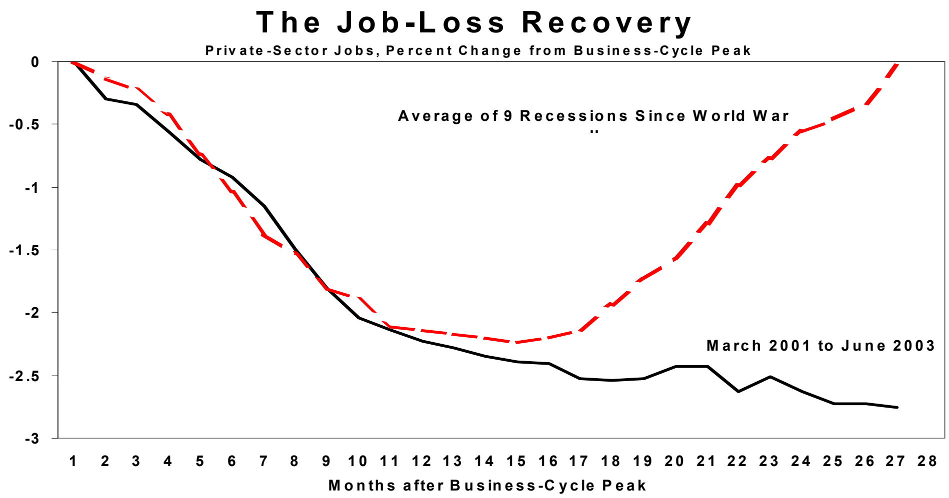
In fact, real growth in the quarter that just ended may have been close to zero, according to the respected economic forecasting firm Macroeconomic Advisers. They believe that real GDP edged up at only a 0.8 percent annual rate in the second quarter. The picture of widespread economic stagnation in the most recent data is not consistent with the *Mid-Session Review*'s assumption that growth is proceeding at more than four times that pace. Indeed, the Federal Reserve continues to signal that it stands ready to take extraordinary steps to head off any incipient economic weakness.

- ***For 21 consecutive weeks, initial claims for unemployment insurance have been above the benchmark level of 400,000, indicating that the pace of job loss remains quite high.*** Meanwhile, help-wanted advertising has fallen to its lowest level since 1961, indicating that those who lose their jobs will find it difficult to get new ones. Similarly, the most recent Manpower Inc. hiring survey shows that employers plan to add fewer new workers in the next three months than at any time in the last twelve years.

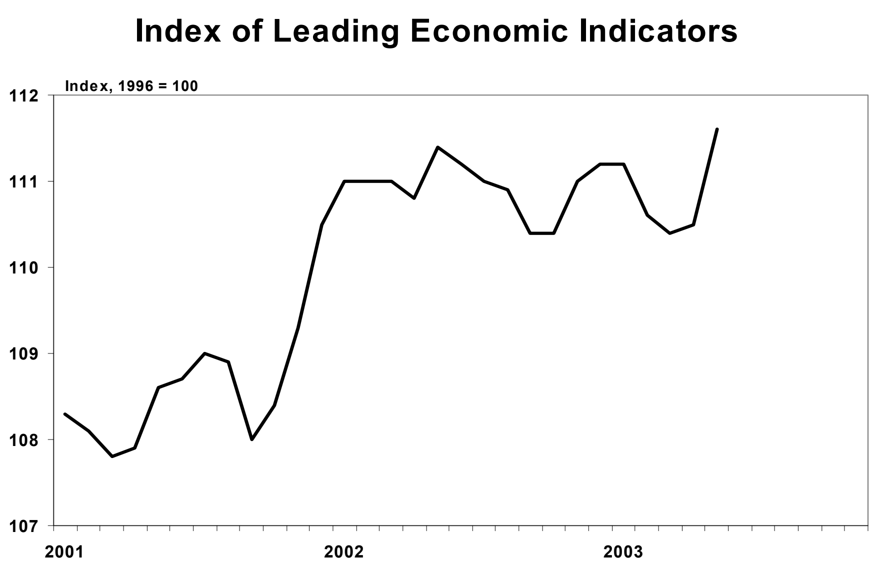




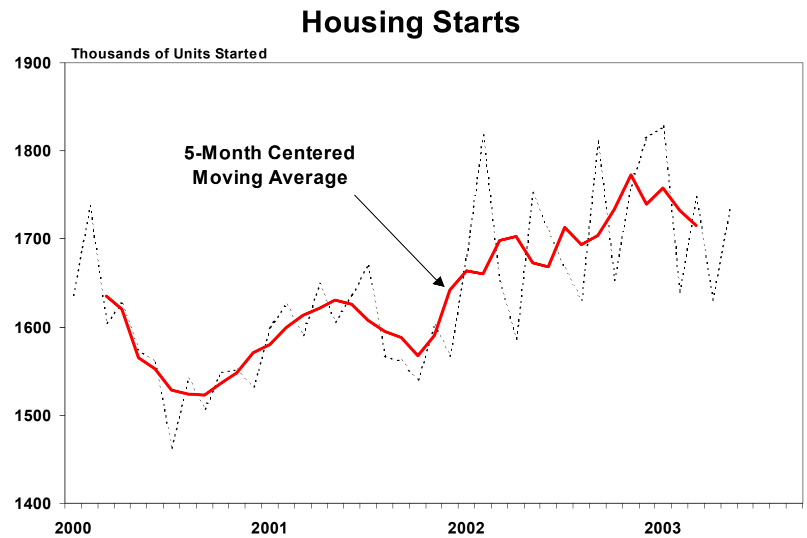
- ***Not surprisingly, employment is falling, not rising as was promised when the tax cuts were passed.*** Since the President took office in January 2001, the economy has lost 3.1 million private-sector jobs, the worst record of any administration since the Great Depression. Since November of last year, the loss of private-sector jobs has been 396,000.



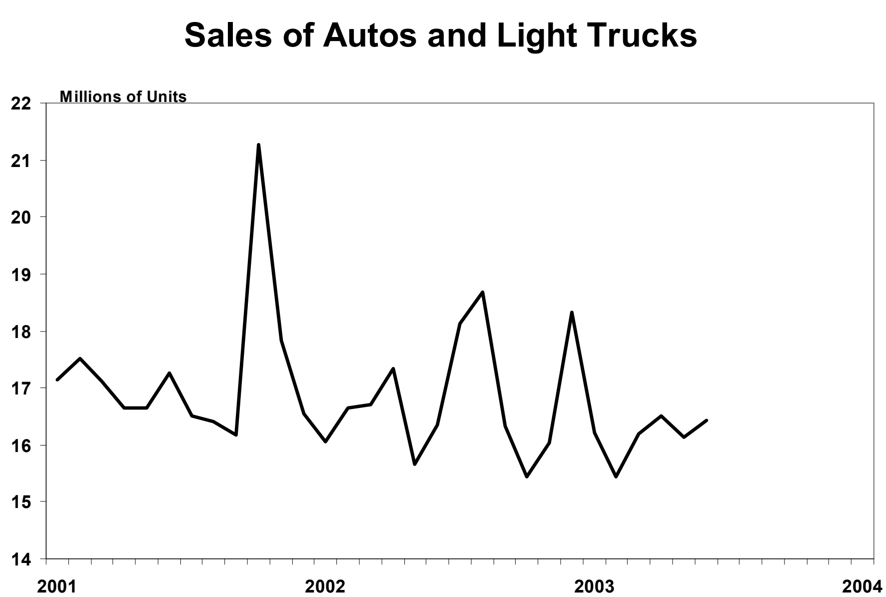
- ***The one-month increase of the index of leading indicators in May is unconvincing.*** Typically, economists like to see three months of consecutive gains in the leading index before concluding that better growth is imminent. However, this chart shows that even that standard can be misleading. The leading index increased smartly in the last four months of 2001, but private-sector employment posted eight consecutive monthly declines in the first part of 2002. The private-sector job count then managed only three months of very weak improvements, before heading down again at the end of the year.



- ***Although housing starts also posted a one-month increase in the most recent data, new home construction actually appears to be on a declining trend.*** The Federal Reserve has kept short-term interest rates below 2 percent for the last year and a half, and this boosted new home building over that period. However, with short-term interest rates already close to zero, it is unlikely a renewed burst of residential construction will contribute to an economic recovery, as it has in the past. In fact, this chart shows that home building may be petering out.



- ***Motor vehicle production is another sector that typically leads the economy to faster growth, but it too appears unlikely to assume its usual role.*** The chart below shows that sales of autos and light trucks have, if anything trended downward over the last year and a half.



- ***New orders for nondefense capital goods have been essentially flat for the past year and a half.*** This indicator of future business investment suggests that firms have little reason to invest as long as existing capacity is unused. Thus, a boost in business investment seems unlikely to lead to faster GDP growth anytime in the near future.

The economy may yet recover in the second half of this year in response to the aggressive easing of monetary policy and three tax cuts in two years. However, data about what is happening in the economy ***right now*** show no convincing evidence that an economic recovery has begun. The assumed recovery that underlies the *Mid-Session Review*'*s* current deficit projections will therefore have to begin immediately if we are to avoid still more deterioration than the Administration's budget figures now show.